Policy Summary of Study 335

The Gathering Pension Storm:
How Government Pension Plans are Breaking the Bank and Strategies for Reform

By George Passantino and Adam B. Summers

An ominous storm cloud is gathering across the horizon as American governments try to pay for the lucrative pension promises made to their employees. And these clouds are not just over a few skies. They are virtually everywhere. Government employee pension systems across the nation are in crisis.

The city of San Diego is now embroiled in its worst financial crisis ever with more than $2 billion in unfunded pensions and retiree healthcare costs. The financial mismanagement led TIME Magazine to name Mayor Dick Murphy one of the nation's three worst mayors, and eventually resulted in Murphy's resignation less than five months into his second term. In Illinois, taxpayers face a $35 billion pension deficit—the worst in the nation. The state of West Virginia faces a $5.5 billion pension deficit and an additional $3.3 billion in unfunded workers' compensation liabilities—a deficit nearly three times the state's annual $3.1 billion general fund budget.

And in California, where government pension fund has become synonymous with investment activism, the California teachers' retirement system faces a shortfall of more than $24 billion and the state pays more than $3 billion each year to keep its retirement funds afloat.

For each government pension system in crisis, another dozen could be listed as this is clearly a national, systemic problem. In fact, American taxpayers are exposed to a total of more than $350 billion in combined unfunded government pension liabilities.

The recent downturn in the stock market is often blamed for these shortfalls. After all, the market suffered a sharp decline beginning in 2000. But is this a fair defense or is it an incomplete answer provided by government officials hoping to rationalize the major run-up of government debt?

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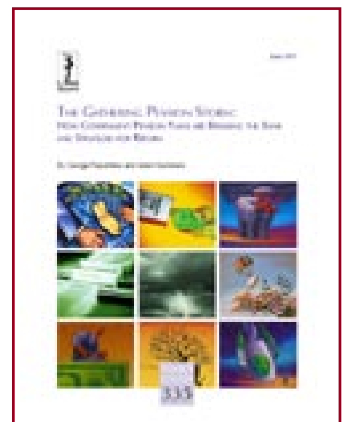

While market losses certainly played a role, the declines only unveiled the weaknesses in government pension systems—weaknesses previously masked by the historic investment gains of the late 1990s. The fact that a retirement system could turn so quickly from investment nirvana to debt nightmares should give taxpayers and lawmakers cause for major concern. Moreover, blaming the market ignores the many policy decisions that have created the crisis.

At the heart of the pension crisis is a set of incentives that encourages policymakers to make decisions for which they do not have to bear the consequences. Since corporate executives, lawmakers, and union officials will not bear the costs of the benefit increases they preside over, there is no incentive for them to show fiscal restraint.

UNDERSTANDING THE CRISIS

The "defined-benefit" pension plan, also referred to as the "traditional" plan, guarantees employees a pre-set benefit upon retirement that can easily be changed by lawmakers. The amount of the benefit is calculated by multiplying a fixed percentage by the number of years that the employee worked for the firm or government agency by the employee's final compensation (or some average of the employee's highest earnings). The employer invests money to ensure that these promises can be kept. If the investment returns do not match up, taxpayers are obligated to make up the difference. Alarmingly, once benefits are bestowed via a defined-benefit plan, the courts have ruled they cannot be taken away.

Because of this reality, taxpayers have been abused to promote political agendas that promise extravagant retirement benefits to government workers—even as the taxpayers themselves work longer to prepare for their own retirement. Significant benefit increases, such as "3 percent at 50" plans, have proven themselves unsustainable. These excessive benefit levels and a variety of government policies have encouraged premature retirement and pension spiking, driving up costs even further.

The mistake of offering greater benefits that governments cannot afford is regularly compounded by poor financial planning. The lack of long-term averaging of investment returns leaves governments susceptible to volatile swings in pension contribution payments. The issuance of pension obligation bonds is little more than an expensive gamble that will saddle taxpayers for years to come. And the very assumptions of which these pension promises are theoretically built can easily be manipulated to the taxpayers' demise. For instance, if a pension fund assumes an overly generous rate of return on its investments or understates the full actuarial costs of benefits, the taxpayers are exposed to a significantly greater risk.

Over the past several decades, the private sector has rapidly shifted away from defined-benefit plans and toward defined-contribution plans for good reason—traditional plans are expensive, unpredictable, and unsustainable in the long run. The government has been slow to follow the private sector's lead. But this is not only a reasonable course of action for governments—it also represents significant benefits to workers too.

As the name implies, the main difference between defined-contribution pension plans and defined-benefit plans is that defined-contribution plans spell out the level of contributions employers and employees will make to the retirement system—not the level of benefit the employee will receive at retirement. Instead, the level of benefit the

How Defined-Benefit Payments are Calculated and Increased

Consider an employee who has worked 30 years and decided to retire with a final salary of $50,000 (whether calculated by the last year of employment or a three-year or other average as most systems do). Had this employee begun working for the employer at age 25, a "2 percent at 55" plan would allow him to retire at age 55 with 60 percent (2 percent times 30 years) of his final salary, for an annual pension of $30,000 (60 percent times $50,000). He would receive this pension benefit (plus a COLA for a typical plan) for the remainder of his life—regardless of how well or poorly the government pension fund performed. The benefits reflect a promise that must be honored. If, however, lawmakers in his community increased the calculation to "2.5 percent at 55" late in his career, the annual retirement benefit would increase by $7500 per year for the rest of his life—even though he didn't contribute at a higher level throughout his career.

employee receives upon retirement depends on the performance of his or her investment portfolio, as well as his or her level of participation. Employees bear the risk of their investments but also get to maintain control of these investments.

One of the greatest benefits of a defined-contribution plan, from a government employer's perspective, is that it provides a great deal of stability since contribution levels are known in advance and do not change much from year to year. This is a sharp contrast to the volatility in contribution levels experienced under defined-benefit plans.

While the stability/predictability argument offers one of the strongest practical benefits of defined-contribution plans, perhaps the greatest moral benefit is that it allows employees the freedom to manage their own retirement accounts and invest their own money as they see fit.

Defined-contribution participants have the freedom to invest their money as they choose and the critical ability to take that entire investment with them from job to job—something defined-benefit plans lack. This portability is extremely appealing to employees in an age where the average worker switches jobs numerous times during his or her career. Bureau of Labor Statistics data illustrate the nature of today's increasingly mobile workforce. In 2000, for example, the median job tenure was 4.7 years. For employees aged 25 to 34, it was only 2.6 years.

Moreover, risk levels and investment strategies change with age and defined-benefit plans do not allow for that individual flexibility. Defined-contribution plans allow employees to choose more aggressive, growth-oriented investments when they are young and switch to more conservative investments as they approach retirement.

Under a defined-contribution plan, lawmakers can still make very appealing retirement packages, including attractive matching options. The defined-contribution plan structure simply requires that these costs be recognized and dealt with in the current year as one of the government's many priorities. Defined-contribution plans prevent lawmakers from creating actuarial liabilities by pushing hidden costs off into the future. This should be reason enough for taxpayers to embrace such a reform.

In addition, there are numerous other steps governments must take to address the pension deficit problem and improve overall financial management of the state to ensure that the current pension crisis does not have a spillover effect.

DEFINED-BENEFIT DANGERS

At the heart of the pension crisis is a set of incentives that create a "moral hazard." The fact that policymakers are able to make decisions for which they do not have to bear the consequences actually encourages risky behavior. Since corporate executives, lawmakers, and union officials will not bear the consequences of the benefit increases they preside over, there is no incentive to show fiscal restraint. Thus, underfunding a system does not create problems until years into the future. But policy leaders do get to reap the political rewards of creating lucrative new benefits for employees or underfunding a system and freeing those monies for other purposes in the short term. Numerous shared pathologies have created this crisis.

Excessive Benefits and Pension Spiking

Over recent years government defined-benefit plans have offered very generous benefits to employees. One justification for this is that higher benefits encourage employees to remain longer, which, in turn, helps to save on the cost of hiring and retraining new employees. Benefits have often been so attractive that the opposite has happened, however, as employees have taken advantage of higher benefits and retired sooner. Thus, employers may end up with higher pension costs and the costs of hiring and training new employees. Some government employers have extremely liberal policies regarding the amount of vacation time that can be "sold back," thus "spiking" their final compensation to increase their pension benefits. In New Jersey, sick time and vacation time sell-back benefits are expected to cost taxpayers nearly $1.5 billion in coming years.

Pension Fraud

One of the more common frauds perpetrated against pension systems is referred to as "Chief's Disease"—the practice of claiming a questionable work-related injury during one's final year of employment in order to receive greater retirement benefits. According to the *Sacramento Bee*, over 80 percent of California Highway Patrol chiefs who retired in the past four years filed disability claims just before they retired. Liberal workers' compensation and disability pension rules as to what constitutes a "work-related" injury also contribute to abuses of the system. Rules have allowed conditions such as cancer and heart disease, for example, to be considered job-related injuries.

Another S& L Bailout?

The Pension Benefit Guaranty Corporation (PBGC) is a quasi-governmental agency that insures the nation's private-sector defined-benefit pension plans, covering 44 million workers. Firms that offer defined-benefit plans pay a small mandatory premium per worker or retiree. If one of these firms goes bankrupt and can no longer afford to pay the benefits, the PBGC steps in and pays the benefits, up to a maximum. The agency went from a $9.7 billion surplus in 2000 to a $23.3 billion deficit in 2004. According to the Center on Federal Financial Institutions, current projections reveal that the PBGC will likely be bankrupt in 2020 if existing financial conditions remain about the same, sparking fears of a taxpayer bailout on the order of the savings-and-loan crisis of the 1980s. The aggregate unfunded liability in private pensions plans ranges from $400 to $450 billion.

Now many are beginning to wonder if the U.S. taxpayer should expect another bailout similar to the S&L bailout of the 1980s.

Unrealistic Actuarial Assumptions

The true costs of pension plans may be hidden by overly-optimistic actuarial assumptions. These errors may be intentional or unintentional. The Fort Worth Employees' Retirement Fund was still projecting investment returns of 8.5 percent a year after the market turned south in 2000. In Contra Costa County, California, a re-evaluation of actuarial assumptions revealed that the county's actual retirement costs for the next fiscal year would be 10 times greater than what had been predicted only five months prior.

"Contribution Holidays" and the "13th Check"

Pension systems also encounter trouble when the government employer neglects to make contributions as a result of strong pension fund performance. When investment returns are so high that the employer is not required to make any contributions to the system that year, the employer is said to enjoy a "contribution holiday."

In other cases, pensions systems disburse "excess" returns to beneficiaries in a special payment known as the "13th check." Not only is the employer not saving or reinvesting these funds, it is actually reducing its assets by giving them away. Worse yet, some municipalities, such as San Diego, have issued a 13th check while in the midst of a pension funding crisis.

Pension Obligation Bonds

While issuing pension obligation bonds is often sold as refinancing a debt, it has rightfully been characterized as a "risky form of arbitrage." This is because the government issuer must gamble that the pension fund's investment return will exceed the payments it must make on the bonds, typically at least 6 percent. Moreover, the idea of issuing one debt to pay another, particularly when issuing bonds to pay an annual operating expense, is poor fiscal policy.

Mixing Politics and Investing

The primary obligation of retirement boards is the maximization of their own "shareholder" value—that is, seeking and earning the highest rate of return for their members. Increasingly, however, government pension bodies have been accused of advancing political agendas, even at the expense of their shareholders. In recent years California's largest state retirement system (CalPERS) has taken positions to punish firms that compete with government employees, foster the development of "environmentally friendly" technologies, and even put pressure on a grocery company involved in a labor dispute with the CalPERS president's union. The New York City Employees' Retirement System (NYCERS) has followed suit, recently warning JPMorgan Chase and several other top Wall Street firms not to support President Bush's push for individual Social Security accounts. In this way, retirement systems have used their members' dollars to advance their own agendas, buying into programs that may not have the best return for the investment.

RECOMMENDATIONS FOR REFORM

Pension reforms need to break the vicious cycle of systematic problems, long-term costs, and short-term budget crises. They demand three separate tracks of action. First, they must focus on fundamentally changing the system to prevent existing problems from getting any worse. Lead-

ers should ask themselves: How do we create a retirement system that allows workers to retire with dignity but does so without creating open-ended obligations for the taxpayers? Second, reforms must tackle existing liabilities. Finally, successful reforms must ensure that pension obligations do not threaten other areas of the budget and quality-of-life services or create pressure for tax increases.

Transition to 401(k)-style Defined-Contribution Plans for all Future Workers

Courts have ruled that there is little ability to take back even the most egregious benefit increases that have already been issued to government employees. As such, major pension reforms must be prospective. Governments should immediately change the package of retirement benefits offered to new workers. Rather than offering a government-run, defined-benefit package, they should allow the formation of new defined-contribution plans similar to the 401(k) most taxpayers enjoy for their own retirement. Over time, the share of employees in defined-benefit plans will reduce and greater predictability in government budgeting will emerge. Moreover, shifting to these plans will better reflect the reality of the modern and dynamic labor market where individuals routinely move from job to job.

Cope with Existing Obligations

Shifting new employees into defined-contribution systems only addresses a portion of the problem. Since this shift only deals with future employees, it cannot address the challenges related to employees already in the current system, such as how to cope with existing debts or how to avoid racking up additional debts in the future. Here, a number of other strategies are in order.

Recommended reforms include:

- Enacting constitutional or charter amendments to require voter approval of all government employee benefit increases;
- Adopting, adhering to, and frequently re-evaluating sound actuarial assumptions;
- Scaling back, or "sunsetting," realized benefit increases for new employees;
- Restricting the definition of "public-safety employee" to the term's original meaning, and
- Re-evaluating government employee retirement ages.
- Increase the number of years used in calculating a pension benefit and avoid "spiking."
- Avoid issuing pension obligation bonds.

Protect the Budget from Pension Overruns

For any government confronting unfunded pension obligations, one of the greatest concerns is to what extent the obligations will crowd out other government programs and negatively impact the quality of life of taxpayers. To ensure that the remainder of the budget is not threatened and that taxes are not increased to fund pension commitments, lawmakers should look at the pension crisis as a call for broader government reform, with the explicit goal of increasing the quality of government services at lower costs. Some strategies include:

- Identifying and divesting unneeded government-owned assets;
- Implementing performance reviews to identify poor-performing and unneeded programs;
- Continually seeking outsourcing opportunities and competition to government services;
- Reforming procurement practices through reverse auctioning, recovery auditing, and updating rules and procedures;
- Consolidating government agencies and functions, and
- Implementing "e-government" reforms.

It is time that governments learn what the private sector concluded decades ago: that defined-benefit plans, typified by exorbitant benefit levels, are simply unsustainable. While few governments overall have made the leap, there are a number that have moved in that direction, including Michigan, Florida, and Oregon. Other states should follow their lead and adopt the private-sector model and switch to defined-contribution systems for all future government workers to ensure more responsible fiscal management that rightly places a focus on providing high quality services.

ABOUT THE AUTHORS

George Passantino is a Senior Fellow in Government Reform for Reason Foundation. Mr. Passantino has authored numerous studies, white papers, and commentaries on California's need for fundamental economic, legislative, and regulatory reform. His views have appeared in

newspapers and radio programs across California and the nation. In 2004, George Passantino served as a full-time Director of the historic California Performance Prior to joining Reason in 1997, he served as a legislative consultant to the California State Legislature. Mr. Passantino graduated cum laude with a Bachelor of Arts in Applied Economics from California State University, Bakersfield. He serves as Regional Manager for TMG Communications, a Southern California public affairs firm specializing in land use, economic development, and local government.

Adam B. Summers is a policy analyst at the Reason Foundation. He has written extensively on privatization, government reform, law and economics, and various other political and economic topics. His articles and studies have been published by Reason Foundation, *Los Angeles Times, Baltimore Sun, San Diego Union-Tribune, Orange County Register, Los Angeles Daily News*, American Institute for Economic Research, Maryland Public Policy Institute, Pioneer Institute for Public Policy Research, and Ludwig von Mises Institute, among others. He holds a Master of Arts degree in Economics from George Mason University and Bachelor of Arts degrees in Economics and Political Science from the University of California, Los Angeles.

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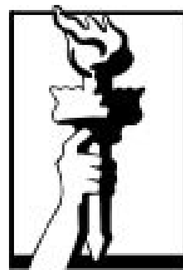

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